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No. 88-36

# In the Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, FINN M.W. CASPERSEN,
ANDREW C. HALVORSEN, PETITIONERS

*v.*

ROBERT M. DEUTSCHMAN, RESPONDENT

**On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit**

## SUPPLEMENTAL BRIEF FOR THE PETITIONERS

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## SUPPLEMENTAL BRIEF FOR THE PETITIONERS

Pursuant to Rule 22.6 of the Rules of this Court, petitioners submit this supplemental brief in response to the *amicus curiae* brief filed by the United States on May 23, 1989.

The government's brief appears to recognize that the court of appeals' legal analysis exposes nontrading corporations to virtually unlimited damages liability under Section 10(b) and that a lower court decision espousing such a rule would merit this Court's attention. Accordingly, the government has carefully attempted to cabin the court of appeals' rationale, depicting this as a case concerning only "standing of options traders" (Br. 4). In the government's view, the decision below does not address the extent to which a nontrading corporation may be held liable in damages under Section 10(b) to persons trading in other types of securities issued by entities other than the corporation itself (Br. 18-19).

Unfortunately, the premise of the government's submission is demonstrably false. The court of appeals' analysis—like the analysis in the government's own brief—leaves no room for any distinction between options and other securities not issued by the defendant corporation. To the contrary, the legal rule adopted by the court below and endorsed by the government extends the Section 10(b) implied right of action to traders in *all* such unrelated securities.

Once the government's unrealistically myopic view of the case is corrected, the significance of the Third Circuit's decision becomes clear: nontrading corporations would be subject to wide-ranging, essentially unlimited damages liability. The question whether Section 10(b) imposes such open-ended liability is an issue of considerable practical importance to the business community on which the lower courts have reached differing conclusions. The petition for a writ of certiorari should be granted.

### A. The Court Of Appeals' Decision Conflicts With The Language Of The Statute And The Principles For Construing Section 10(b) Set Forth In This Court's Decisions

The government suggests (Br. 4-8) that the Third Circuit's decision is simply a logical extension of prior case law defining the scope of the private right of action implied under Section 10(b). That is plainly incorrect. Citing this Court's observation that "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn" (*Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)), the district court correctly recognized that the issue in this case is whether the "oak" should be "engrafted with a new limb from which numerous branches would inevitably sprout." Pet. App. 18a. Until now, a nontrading corporation's liability in damages for public misrepresentations has extended only to persons who traded in securities *issued by the corporation itself* (see, *e.g.*, *Basic Inc.* v. *Levinson*, 108 S.Ct. 978 (1988)); the decision below breaks new ground by holding the corporation liable to persons who traded in securities *issued by other entities.*[1]

1. It is important to emphasize at the outset that this Court has *never* held that a corporation may be subjected to liability under Section 10(b) for public misrepresentations where the corporation itself did not participate in the trading of the securities that were the focus of the

[1] This case involves only the scope of the private right of action implied under Section 10(b). Despite a hint by the government to the contrary (Br. 7), the authority of the Securities and Exchange Commission to obtain injunctive relief is not in dispute and would not be limited by the standing rule that we advocate. Cf. *Blue Chip Stamps*, 421 U.S. at 751 n.14.

Similarly, there is no question that options are securities within the meaning of Section 10(b). (The government's discussion of this matter (Br. 6) is thus completely irrelevant.) The issue here is whether an options trader may maintain an action for damages under that provision against a nontrading corporation *other than* the issuer of the options.

alleged fraud. Justices White and O'Connor observed in their separate opinion in *Basic Inc.* v. *Levinson*, *supra*, that "'[i]mposition of damages liability under Rule 10b-5 makes little sense . . . where a defendant is neither a purchaser nor a seller of securities.' * * * [I]t is difficult to square liability in [such a] case with § 10(b)'s express provision that it prohibits fraud '*in connection with* the purchase or sale of any security.'" 108 S.Ct. at 998 (citations omitted; emphasis in original). The four-Justice majority in *Basic* did not address the issue; the Chief Justice, Justice Scalia, and Justice Kennedy did not participate.

The situation here is even farther removed from Section 10(b)'s language than the one criticized in *Basic*. At least the nontrading corporation in *Basic* was being sued by persons who, allegedly in reliance on public misrepresentations made by the corporation, had traded in the corporation's own securities. In view of the preexisting relationship between the corporation and its own securities, all of the corporation's statements might in some sense be said to have a "connection with" trades in those securities. Here, as the government acknowledges (Br. 2-3 & n.2), there is absolutely *no* connection between Beneficial Corporation and the options purchased by respondent. Not only did Beneficial not trade in those securities, but it also did not issue them. It is therefore impossible to see how Beneficial's statements are "connect[ed]" in any way to trading in these wholly unrelated securities. Thus, nothing in the language of Section 10(b) authorizes respondent's cause of action.

The government's analysis of the statutory language is quite bizarre. It concedes (Br. 7-8 n.7) that if the statute prohibited an unlawful act "in connection with a security," the plaintiff would be required to prove the existence of a relationship between the defendant corporation and the security. According to the government, however, the existing statute—which makes it unlawful for any person to use or employ a manipulative or deceptive device "in connection with the purchase or sale of

any security"—shifts the test to a subjective standard demanding proof only that the plaintiff's own decision to trade was affected by the corporation's misstatement.

The government does not explain why this seemingly inconsequential difference in wording should change the standard from an objective test to a subjective one looking to the plaintiff's own decisionmaking process. The statute remains focused on the relationship between the defendant and the securities transaction at issue: *i.e.*, whether the *defendant* used or employed an unlawful device in connection with the purchase or sale of the particular securities. Moreover, the government's approach has the additional defect of rendering this element of the cause of action wholly duplicative of the materiality and reliance requirements. Whenever a plaintiff has satisfied the latter tests, he would of necessity have established that, in his view, the challenged conduct occurred "in connection with" the securities transaction. This construction of the statute would therefore be inconsistent with the well-settled principle that statutes should be interpreted to give effect to all of their terms.[2]

2. This Court has held that, in determining the scope of the judicially-created private right of action under Section 10(b), courts should take policy considerations into account in "flesh[ing] out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip Stamps*, 421 U.S. at 737; see also *Santa Fe Industries* v. *Green*, 430 U.S. 462, 477-479 (1979). Because the court of appeals' construction of Section 10(b) would lead to an unprecedented—and un-

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[2] The government somewhat mysteriously asserts (Br. 3 n.4) that we do not rely on the district court's determination that *Blue Chip Stamps* requires a Section 10(b) plaintiff to show that he traded in securities issued by the defendant corporation. As we have discussed, our argument is precisely that: a plaintiff in this sort of Section 10(b) action has standing only if he has traded in securities issued by the defendant.

justified—expansion in the scope of damages liability, that interpretation of the statute should be rejected.[3]

Contrary to the government's repeated assertions (Br. 5, 8, 11-12, 17), the legal issue in this case is not simply whether options traders may bring suit against a non-trading corporation. The court of appeals concluded—and the government agrees (Br. 7)—that Section 10(b) requires absolutely no connection between the defendant and the securities transaction engaged in by the plaintiff. Under the court's theory, a non-trading corporation may be held liable in damages to a trader of *any* security—whether issued by the corporation or not—as long as the trader can prove the other elements of the cause of action.

The potential expansion of liability under this rule is enormous. Assume, for example, that IBM issued a press release falsely stating that it had developed a new computer with superior capabilities. The misrepresentation would likely inflate the price of IBM securities, and it almost certainly would also depress the prices of securities issued by Apple, Wang, Data General, and IBM's other competitors. Under settled law, persons trading in IBM securities could recover damages from IBM based on the misstatement. Under the court of appeals' new legal test, however, persons trading in shares issued by these other corporations—and, presumably, persons trading in options to purchase or sell the shares of those corporations—also would be entitled to recover damages from IBM. The same result would seemingly obtain for

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[3] A standing rule is particularly necessary in cases involving public misrepresentations by a nontrading defendant because, in contrast to other sorts of claims under Section 10(b), there is no inherent limitation on the scope of the defendant's damages liability. In the insider trading context, for example, the defendant is liable only to contemporaneous traders in the same security. Where there are face-to-face misrepresentations by a nontrader with respect to a particular transaction, the defendant's liability would be limited to the participants in that transaction. It is only in the public misrepresentation context that a defendant is exposed to truly unlimited liability.

persons trading in securities issued by companies such as software suppliers, whose business is dependent upon compatibility with IBM products. And the same result presumably would follow for persons buying or selling securities (such as "baskets" (see Pet. 10)) that depend upon the price of IBM shares.

This has never been and should not be the law; yet it is precisely what the court of appeals' decision portends. The staggering damages liability that would result would be crippling to corporations as well as other potential defendants. Despite that, *neither the court of appeals nor the government has presented any legal basis for distinguishing between options and all other unrelated securities.* (The government seeks to fill this void by pointing out (Br. 15 n.19) the *factual* basis for conferring standing on options traders. But the economic link between a corporation's stock and another security is hardly unique to options, and in any event it supplies no *legal* distinction between options and other securities.) This Court should intervene to prevent such an enormous and unwarranted expansion of the scope of damages liability under this implied right of action. See *Associated General Contractors* v. *California State Council of Carpenters*, 459 U.S. 519, 534 (1983) (limiting class of potential antitrust plaintiffs on the basis of similar policy concerns).[4]

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[4] In view of the broad potential impact of the court of appeals' rule, the government's policy arguments (Br. 11-17) designed to show the reasonableness of permitting recovery by options traders are beside the point. The legal rule at issue here will have an impact far beyond the options context. In any event, these policy arguments are insubstantial. The government acknowledges (Br. 11) that there is "some force" to the argument that granting standing to options traders is unnecessary because in every case in which options traders could bring suit, an action could be brought by a corporation's present or former security holders. The government goes on to hypothesize (Br. 11-12), however, that options traders may have more of an incentive to sue in cases where the alleged misrepresentation produces only a small movement in the price of the corporation's own securities. But modern class actions provide the corporation's securities holders with an

3. The government implicitly acknowledges the dramatic change worked by the decision below, because it strains to emphasize other safeguards that it contends are sufficient to prevent the imposition of excessive damages liability under Section 10(b). Thus, the government suggests (Br. 14) that courts could—on a case-by-case basis—impose a cap on the total amount of damages liability that a defendant would have to bear.

This is a familiar tune. In *Blue Chip Stamps*, the Securities and Exchange Commission argued that the Court should not limit the class of private plaintiffs under Section 10(b) to persons who bought or sold securities, suggesting instead other limits upon the scope of Section 10(b). See 421 U.S. at 746-747 n.10. And in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the Commission argued against imposition of a scienter re-

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incentive to sue even if the harm to each individual is quite small. (The government itself notes (Br. 12-13 & n.14) that the number of trades of the corporation's own securities is likely to be many times the trades of options; in virtually every case, therefore, the class of traders in corporate securities would certainly be large enough to provide sufficient incentive for a damages action.) There is thus no deterrence rationale for this expansion of liability.

Second, the government contends (Br. 12) that providing a damages remedy for options traders furthers Section 10(b)'s remedial purposes. But this Court in *Blue Chip Stamps* and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), refused to construe Section 10(b) to ensure compensation for all persons misled by a defendant's misrepresentation, holding that other policy considerations outweighed that interest. The same is true here.

Finally, the government argues (Br. 14-16) that subjecting a corporation to liability at the hands of options traders comports with the common law rule. Again, the Court in *Blue Chip Stamps* squarely rejected the identical argument, refusing to define the private action implied under Section 10(b) by reference to the relevant common law tort concepts, because "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." 421 U.S. at 744-745. Especially in view of the relaxed reliance standard embodied in the "fraud on the market" theory, a Section 10(b) claim simply cannot be analogized to a common law tort action.

quirement, putting forward alternative restrictions on the private right of action. 425 U.S. at 197-198 & n.18. This Court in each case rejected the government's invitation to broadly construe one element of the cause of action on the theory that any unwarranted liability could be eliminated by tinkering with the other elements of the claim. So here, the Court should impose rational limits on the scope of liability through a standing requirement and not rely on a hypothetical "fix" not responsive to the particular problem presented by this case- -unwarranted expansion of the class of potential plaintiffs.

The government also asserts (Br. 14) that the requirement that plaintiffs prove the other elements of Section 10(b) liability—scienter, materiality, and reliance—will restrict a corporate defendant's damages liability. But these assurances are cold comfort to companies that must bear the expense and inconvenience of defending such actions. The possibility that nonmeritorious claims might be weeded out at trial simply does not eliminate the burden imposed upon corporations by the existence of pending suits carrying the threat of huge monetary liability. The Court made these very points in rejecting a similar argument in *Blue Chip Stamps.* See 421 U.S. at 739-743.[5]

In sum, the language of the statute, relevant policy considerations, and this Court's precedents establish that Section 10(b) should not be construed to subject a corporation to monetary liability when it has neither traded in nor issued the securities in question.

### B. Review By This Court Is Appropriate Now

The government concludes that a grant of certiorari is "not warranted at this time" (Br. 5), apparently be-

[5] The government asserts (Br. 13-14 n.16) that *Blue Chip Stamps* is irrelevant, because the Court's decision rested solely on concerns about the unverifiable nature of non-traders' claims. In fact, the Court relied upon "two largely separate grounds" (421 U.S. at 740), one of which was the burden imposed by meritless "strike" suits (*id.* at 740-741, 742-743).

cause in its view there is no conflict among the courts of appeals, certain other issues regarding the scope of the cause of action remain unresolved, and the issue in this case is limited to suits by options traders (Br. 17-19). As we have discussed, the last point is simply wrong. The legal rule adopted by the Third Circuit expands the scope of a corporation's Section 10(b) damages liability well beyond options traders. For that reason alone, this Court should grant review.

The fact that the lower courts that allow options traders to recover damages have not yet fleshed out every rule governing the scope of that liability provides no reason for the Court to decline to address the threshold standing question presented in this case. The Court decided the substantially analogous standing issue in *Blue Chip Stamps* despite the fact that many rules governing the implied private action—such as the proper measure of damages and the proof necessary to show reliance—were then unresolved.

Finally, as we argued in the petition (at 17-22) and our reply brief (at 2-3), we disagree with the government's conclusion regarding the state of the law in the lower courts. First, *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (8th Cir. 1982), cert. denied, 464 U.S. 846 (1983), conflicts with the decision below. *Laventhall* plainly stands for the proposition that a corporation has no duty to speak truthfully to traders of securities that are strangers to the corporation. Second, contrary to the picture that the government tries to paint (Br. 17-18 n.24), there is substantial confusion among the district courts. Three courts have reached the same result as the court below, and three courts (including the district court in this case) have rejected that view. See *Starkman* v. *Warner Communications, Inc.*, 671 F. Supp. 297, 299, 301-307 (S.D.N.Y. 1987); *Bianco* v. *Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).[6]

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[6] The government erroneously asserts (Br. 18 n.24) that *Starkman* involved only insider trading claims. However, the court's opinion

This confusion about a basic issue of securities law is intolerable. There has been an explosion in the trading of options and other derivative securities. See Pet. 7-11. The large number of reported decisions addressing the precise issue presented in the petition illustrates that options traders seek to recover damages under Section 10(b) with considerable frequency. (Now that this sort of claim has been endorsed by a court of appeals, it is likely to be asserted with increasing frequency. Indeed, future securities class actions will routinely include a claim on behalf of options traders, thereby complicating the litigation and increasing the settlement value of the case.) And, as we have discussed, the court of appeals' analysis cannot logically be limited to options. It subjects a corporation to liability to traders in *any* security.

This Court observed in *Blue Chip Stamps*, 421 U.S. at 741, that "to broadly expand the class of plaintiffs who may sue under Rule 10b-5 would appear to encourage" the use of the liberal provisions of the Federal Rules of Civil Procedure to extort large settlements from corporations wishing to avoid the inconvenience of discovery, even where the underlying claim is entirely frivolous. See also *id.* at 740. The practical burden of inflated litigation and settlement costs imposed by the erroneous decision below is real and ongoing and will be borne by defendants as long as that decision is permitted to stand. Because the rule adopted by the court of appeals also carries enormous potential for complex litigation and staggering monetary liability, this Court should resolve the issue now.

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makes clear that the case also concerned "material misrepresentations made by defendants to the public and * * * to the SEC." 671 F. Supp. at 299; see also *id.* at 305. Indeed, the court relied upon the decision of the district court in the present case and the decision in *Bianco*. See 671 F. Supp. at 306-307. Finally, the decision in a companion case (*id.* at 299) establishes beyond a doubt that the corporation itself was sued on a theory of nontrading liability. *In re Warner Communications Securities Litigation*, 618 F. Supp. 735, 739, 741-743 (S.D.N.Y. 1985).

Respectfully submitted.

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